

April 13, 2001

Ms. Roberta D. Purcell
Assistant Administrator
Telecommunications Program
Rural Utilities Service
United States Department of Agriculture
1400 Independence Ave., SW
Stop 1590
Room 4056-S
Washington, DC 20250-1560

Re: Response to Request for Information ("RFI"), Public Law 106-553, "Launching Our Communities' Access to Local Television Act of 2000."

Dear Ms. Purcell:

KPMG Consulting, Inc. ("KPMG Consulting") appreciates the opportunity to respond to the Rural Utilities Service's Request for Information relating to the Local Television Act of 2000 (the "Act"). This letter specifically addresses Question 5: "What additional factors should be considered to accomplish the goals of the Act?"

KPMG Consulting has considerable experience in providing advisory services related to federal credit programs. For example, KPMG Consulting assisted the Emergency Loan Guarantee Board (ELGB) in administering its loan guarantee programs. Congress passed the "Emergency Steel Loan Guarantee Act of 1999" and the "Emergency Oil and Gas Guaranteed Loan Program Act" in order to provide much needed credit to ailing steel and oil and gas companies. These programs are intended to aid qualified steel and oil and gas companies in obtaining credit that would not otherwise be available from private banking and investment institutions. The Emergency Loan Guarantee Board (ELGB) was established to administer the steel and oil and gas loan guarantee programs.

Similar to the Local Television Loan Guarantee Board ("LTLGB"), the membership of the ELGB is drawn from several federal agencies. The specific members of the ELGB are the Secretary of Commerce, the Chairman of the Board of Governors of the Federal Reserve, and the Chairman of the Securities and Exchange Commission, or their respective designees. Thus the LTLGB and the ELGB have two members in common: the Secretary of Commerce and the Chairman of the Board of Governors of the Federal Reserve.

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Specifically, KPMG Consulting provided assistance in the following areas:

- Developing uniform underwriting criteria
- Reviewing borrower applications in conjunction with the criteria
- Developing a model for estimating credit subsidies for the loan guarantee applications
- Complying with the Credit Reform Act of 1990
- Developing policies and procedures for portfolio management

We have also performed significant consulting services to other federal agencies with Federal Credit/Guarantee programs, including the Federal Housing Administration, the Government National Mortgage Association, the Small Business Administration and the Department of Education. Our work in these areas inform the comments offered in this letter. Specific comments will be offered in the areas of Application Requirements, Underwriting Guidelines and Credit Reform Issues.

Application Requirements

It is crucial to the ultimate success of the program that input be actively solicited from the financial community regarding the proposed regulations. In the case of the ELGB, a lack of consultation with the banking community prior to issuance of the program regulations was believed to have limited participation in the programs.

For example, the maximum loan amount eligible for guarantee under the oil and gas program was \$10 million. Most energy lending institutions, however, do not provide loans of less than \$10 million. As a result, participation in the programs was limited to regional and community banks. Creating market awareness of the program and educating this geographically-disperse group of financial institutions on government loan guarantee programs proved to be a challenge. Moreover, many of these institutions lacked the resources necessary to meet the requirements of the ELGB program. This resulted in participation levels that were below original expectations. It also made the program relatively expensive because administrative costs were spread over a small portfolio. These smaller institutions often did not have significant experience in underwriting and servicing energy sector loans. Early communication with the financial community could have identified these issues and provided an opportunity to address them.

The ELGB program regulations originally required audited financial statements from all borrowers. This requirement was in line with customary requirements for financing steel companies. Lenders to the oil and gas industry, however, do not usually require audited financial statements for all borrowers. Lending to the oil and gas industry is usually viewed as "project finance." That is, the cash flows from the specific project financed are the anticipated repayment source and less emphasis is placed on the sponsoring enterprise's financial condition. Banks that serve this industry instead place greater

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weight on an independent engineering report to assess anticipated production-related cash flows. The requirement that smaller oil and gas producers furnish audited financial statements may have excluded otherwise creditworthy borrowers from participating in the program.

The ELGB program regulations did not allow for the refinancing of existing debt from proceeds of guaranteed loans. This practice was consistent with the programmatic goal of encouraging the flow of *additional* capital into the industry. The program was not designed to enhance already-existing credit facilities. Nonetheless, strict observance of this practice could in certain circumstances limit the program staff's flexibility in responding to credit proposals. For example, if a bank had \$5 million in existing exposure to an oil and gas customer and sought to increase the loan amount to \$10 million, they could potentially be excluded from participation in the program. Thus, additional capital would not be available to this hypothetical customer that may otherwise be creditworthy. An alternative would perhaps be for a bank to be eligible for a guarantee of the incremental proceeds lent so long as the lender does not reduce its existing exposure to the customer. Thus, the additional \$5 million would be eligible for an 85 percent guarantee, so that if the financing was structured as one credit facility (in order to maintain proper lien priority) the effective overall guarantee could be limited to 42.5 percent.

The government's need to mitigate the risk inherent in offering loan guarantees and the objective of maximizing program participation are often in conflict. The financial community found certain provisions of the guarantee application unduly onerous. This caused some banks to drop out of the program. The original requirement that quarterly status reports be delivered within three days was deemed unreasonable. Failure to meet the deadline could result in the termination of the guarantee. Thus, a lender could potentially lose the benefit of the guarantee due to a relatively minor administrative error.

The structure of the loan guarantee program must provide adequate incentives that encourage sound loan origination and servicing. This requirement must be tempered, however, with an understanding of the market's reaction to program requirements.

KPMG Consulting suggests that a focus group of potential lenders be convened in order to assess their perspectives on anticipated requirements of the Local Television Guarantee Board ("LTGB") and to explore opportunities for modifications that would meet the government's needs while enhancing participation.

Underwriting Guidelines

Another significant challenge faced in administering the ELGB programs related to the inherent tension between the requirement that loans approved have a "reasonable chance of repayment" and the eligibility requirements. Specifically, these eligibility

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requirements required that the underlying borrowers demonstrate that they have experienced layoffs, production losses or financial losses and that they have been unable to obtain credit at reasonable terms elsewhere.

Arguably, if a borrower has experienced layoffs, production losses or financial losses and is unable to obtain credit elsewhere, it may be difficult to be confident that a reasonable chance of repayment exists. Some guidance for appropriate risk levels was obtained through a review of the allocated credit subsidy for each loan guarantee program. For example, the oil and gas loan guarantee program was allocated a credit subsidy of \$122 million on a program level of \$500 million. This implicit credit subsidy rate was 28.7 percent. This could be viewed as the anticipated expected loss rate for the portfolio.

The loan guarantee programs outlined in the Act require that applicants demonstrate that they may not obtain credit elsewhere under reasonable terms. Evidence of layoffs and financial losses does not appear to be necessary, however. Nonetheless, the requirement that program borrowers demonstrate an inability to obtain credit elsewhere while still being expected to repay the debt does present a challenge. The Act requires that underwriting criteria that are consistent with the purpose of the Act be established by the Local Television Loan Guarantee Board in consultation with the Director of the Office of Management and Budget (“OMB”) and an independent public accounting firm. These criteria should offer clear guidance as to appropriate risk tolerances that would be deemed reasonable by knowledgeable third parties.

Credit Reform Issues

The credit subsidy estimation process for credit programs typically involves an analysis of historical default and recovery experience. For new credit programs such as the LTLGB program where historical information does not exist, the estimation process becomes more complex. In assisting the ELGB in preparing its credit subsidy estimates, KPMG Consulting, Inc. devised a model that used historical proxy data and industry specialists to estimate default and recovery rates for loan guarantee applications. The methodology and model employed were approved by OMB.

KPMG Consulting recommends that the LTLGB develop a similar approach. Emphasis should be placed on the use of historical third party data that can be closely correlated to the credit profile of LTLGB applications in order to estimate credit subsidies.

KPMG Consulting used an historical database of commercial loan transactions to obtain historical default experience for loans with similar credit profiles. Independent industry experts then reviewed and adjusted collateral valuations to develop reasonable recovery rate assumptions. This recovery information was analyzed in conjunction with the estimated default data to estimate expected loss values. This information was then input into the OMB credit subsidy calculator in order to obtain the final credit subsidy estimate.

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We look forward to the scheduled meeting with you on April 27, 2001 at 10:00 a.m.
Please contact me at (703) 747-3056 or Jim Steck at (202) 533-4754 if you would like to
discuss any of these comments in advance of the meeting.

Sincerely,

KPMG Consulting, Inc.

Timothy F. Kenny
Managing Director